

I. INTRODUCTION

A bank's board of directors is responsible for ensuring the proper and profitable conduct of banking activities, the safety of the bank's assets, and the accuracy and adequacy of periodic reports to shareholders, regulatory bodies and, in some instances, the general public. As a result, the primary responsibility for creating, implementing and policing a system of internal control rests with the bank directorate. Rarely, if ever, can the board personally discharge the many duties stemming from these responsibilities. The workload usually demands delegation to management and nonmanagement employees. Increases in bank size and in the complexity and variety of operations have resulted in the need for a continually growing and changing series of interrelated operating procedures intended to establish and maintain control over delegated duties. These continual changes require that any bank's system of internal control be periodically reviewed and updated in order for it to be effective.

Internal control comprises the plan of organization and all coordinate methods and measures adopted within the bank to safeguard its assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. The American Institute of Certified Public Accountants has subdivided this broad definition of internal control into two components which may be characterized as Administrative Control and Accounting Control.

Administrative Control includes, but is not limited to, the plan of organization and the procedures and records concerned with the decision processes leading to management's authorization of transactions. Such authorization is a management function directly associated with the responsibility for achieving the objectives of the organization and is the starting point for establishing accounting control of transactions.

Accounting Control comprises the plan of organization and the procedures and records concerned with the safeguarding of assets and the reliability of financial records. Consequently, it is designed to provide reasonable assurance that

transactions are executed in accordance with the board's general or specific authorization;

transactions are recorded as necessary to maintain accountability of assets and to permit preparation of financial statements in conformity with generally accepted accounting principals (or any other criteria applicable to such statements); access to assets is permitted only in accordance with prescribed authorization; and the recorded accountability for assets is compared with existing assets at reasonable intervals, and appropriate action is taken with respect to any differences.

The foregoing definitions are closely interrelated because some of the procedures and records included in accounting control may also be involved in administrative control.

The balance of this section is primarily concerned with the discussion and evaluation of internal accounting controls. Commentary on various aspects of administrative controls, e.g., policies, practices, and procedures, are included in other sections of this Manual.

II. BASIC ELEMENTS OF AN INTERNAL CONTROL SYSTEM

Internal accounting controls are the techniques employed to prevent and detect errors in the processing of data and to safeguard assets and the reliability to financial records. Many internal control techniques are built into a bank's operating system so that they appear to be part of normal processing of a given task. Any attempt to identify and evaluate a bank's overall system of controls requires that individual activities be viewed in the perspective of the bank as a whole. The relative importance of an individual control, or lack thereof, must be viewed in the context of other control procedures that are in place. Every bank is unique and one set of internal procedures, or for that matter, even a few sets of alternative procedures, cannot be prescribed for all cases. There are, however, certain basic principles and procedures that must be present in any bank to ensure the adequacy of internal control. These include: development of an effective organizational structure; establishment of appropriate accounting procedures; provisions for protection of assets; and development and use of an effective audit program.

Organizational Structure

The control environment begins with the bank's board of directors which is responsible for the development of objectives and policies and for monitoring adherence. The policies established should ensure that decision-making authority is vested at the proper level of management and that management decisions and policies are properly implemented throughout the organization. An effective audit committee of the board of directors, made up of or including outside directors, is desirable to accomplish that responsibility.

A bank's organization plan must have the complete backing of its board of directors and must establish clear lines of authority and responsibility. It must also segregate the operating and recording functions and provide employees who are qualified to perform their assignments. From an organizational viewpoint, an internal control system, at a minimum, should provide for the items listed below.

Directors' Approvals - Limitations imposed by a bank's board of directors with regard to authority levels, such as lending and investment authority and responsibilities, should be clearly detailed in (preferably) written job descriptions. Actions taken by active officers should be subject to periodic review by the board or a committee thereof. This control feature should provide for a reporting system which will keep the directors informed of such items as new loans, overdue loans, overdrafts, securities transactions, statements of condition and income, and expense and audit reports.

Segregation of Duties - The participation of two or more persons or departments in a transaction causes the work of one to serve as proof for the accuracy of another. Additionally, when two or more persons are involved in a transaction, the possibility of fraud diminishes considerably. Ideally, duties should be arranged so that no one person dominates any transaction from inception to termination. For example, a loan officer should not be allowed to disburse loan proceeds; those having authority to sign checks should not be assigned to reconcile correspondent bank accounts; records should be reconciled to the general ledger by someone other than the one originating the entries; and EDP service center personnel should not initiate transactions or correct data except when such activity may be required to complete processing in a reasonable

period of time (if this unusual situation arises, transactions should be approved by appropriate levels of management at the data center and at the serviced institution).

Rotation of Personnel - Planned and unannounced rotation of duties is an important principle of internal control. The rotation should be of sufficient duration to be effective. Rotation of personnel, besides being an effective internal check, can be a valuable aid in the bank's overall training program.

Sound Personnel Policies - Sound personnel policies are also conducive to establishing an effective control environment. Such policies should include hiring employees for positions commensurate with their skills, effective training of employees before assignment to more responsible positions, and evaluating and reviewing job performance with each employee.

Vacation Policies - It is the FDIC's goal that all banks have a vacation policy which provides that active officers and employees be absent from their duties for an uninterrupted period of not less than two consecutive weeks. Such a policy is considered an important internal safeguard largely because of the fact that perpetration of an embezzlement of any substantial size usually requires the constant presence of the embezzler in order to manipulate records, respond to inquiries from customers or other employees, and otherwise prevent detection. It is important for examiners and bank management to recognize that the benefits of this policy may be substantially, if not totally, eroded if the duties performed by an absent individual are not assumed by someone else. Where the bank's policy does not conform to the two-week recommended absence period, examiners should encourage the board of directors to annually review and approve the policy actually followed and the exceptions allowed. It is important in such cases that adequate compensating controls be devised and strictly enforced. When it is determined, after thorough consideration of all relevant facts and circumstances, that the bank's vacation policies are deficient, the matter should be discussed with the chief executive officer or directors. Comments and recommendations on the supplemental Internal Routine and Controls schedule may be appropriate.

Accounting Procedures

The adoption of an accounting system that is flexible in its capacity and rigid in its controls and standards, promotes accuracy and efficiency and holds costs to a minimum. Such a system is considered basic to any system of internal controls.

An efficient banking operation cannot be conducted without a recordkeeping system capable of generating a wide variety of internal information and reports. Such a system is necessary if a bank's board of directors is to be kept well informed and maximum managerial effectiveness achieved. Furthermore, the needs of customers, supervisory agencies, and tax authorities must be met. Banks are also often called upon to produce certain records in court.

While it is expected that forms, records, and systems will differ from bank to bank in varying degrees, the books of every bank should be kept in accordance with well-established accounting and banking principles. In each instance, a bank's records and accounts should reflect its actual financial condition and accurate results of operations. The following characteristics should be found in a bank's accounting procedures.

Operating Responsibilities - The accounting system should be designed to facilitate preparation of internal reports that correspond with the responsibilities of individual supervisors and key employees.

Current Records - Records should be updated daily, reflecting each day's activities separately and distinctly from that of another day. The records should show the bank's financial condition as of the given date.

Subsidiary Control Accounts - Subsidiary records, such as those pertaining to deposits, loans, and securities, should be kept in balance with general ledger control figures.

Audit Trail - The records and systems should be designed to enable tracing any given item as it passes through the bank's books. The following recordkeeping deficiencies are some of the more prevalent encountered during examinations:

1. General ledger entries fail to contain an adequate description of the transaction;

2. Customer loan records are incorrect, inadequate or totally nonexistent;
3. Permanent and satisfactory records pertaining to cash items, overdrafts, and other types of suspense or holding items are lacking;
4. Tellers' cash records do not contain adequate details;
5. Securities registers, whether processed electronically or manually, fail to list all necessary information;
6. Reconciliation records of correspondent bank accounts are not kept current and/or fail to reflect the description and disposition of outstanding items;
7. Details concerning debits and credits to the over and short accounts are inadequate;
8. Accounts and records are not posted on a current basis;
9. Control and subsidiary records of outstanding letters of credit or other contingent liabilities are inadequate; and
10. Interbranch or interoffice (main to branch) accounts are not properly controlled and monitored.

Prenumbered Documents - Sequentially numbered instruments should be used wherever possible. This will aid in proving, reconciling and controlling used and unused items. Number controls, including printer's confirmation, should be policed by a person who is detached from the particular operation. Unissued, prenumbered instruments that could be used to obtain funds should be maintained under dual control.

Accounting Manual - The uniform handling of like transactions is essential to the production of reliable reports. Accordingly, it is essential that instructions be established for processing routine transactions. In smaller banks where some or all records are manually produced, it may be advisable to reduce instructions to writing, possibly in the form of an accounting manual.

In banks where some or all records are computer generated, there should be an understandable

user's guide for each application readily available for reference by user departments and personnel. Manuals for each application normally consist of a guide provided by the servicer and supplemented by procedures written by the user. Manuals normally delineate preparation and control source documents and certain practices pertaining to control over the movement of documents from the user to the servicer and their return, the daily reconciliation of totals to general ledger, and changes to master files.

Protection of Physical Assets

A principal method of safeguarding assets is to limit access by authorized personnel. Protection of assets can be accomplished by various procedures, including those listed below.

Cash Control - Tellers should be provided with their own funds to which they have sole access. Common cash funds should not be utilized. Inability to fix responsibility in the event of a difference could be embarrassing and is unfair to all concerned.

Joint Custody or Dual Control - These two terms are not synonymous but are often discussed in tandem. Joint custody refers to a procedure whereby two or more persons are equally accountable for the physical protection of certain items or records. An example consists of two keys or combinations, under the separate control of two individuals, which must be used in order to obtain access to vaults, files or other storage devices. These custodial responsibilities should be clearly assigned and communicated to all employees. For this system to be effective, persons exercising control must guard their key or combination carefully. If this is done, only collusion can bypass the important control feature. Reserve cash, negotiable collateral, investment securities, trust assets, safekeeping items, reserve supply of official checks, unissued electronic debit or credit cards, unissued traveler's checks, unissued Series E Bonds, the night depository, electronic banking terminals, dormant deposit accounts, safe deposit spare locks and keys, and spare keys to tellers' cash boxes are examples of items that should be under effective joint custody. Dual control is a related but slightly different concept in which the work of one person is verified or approved by another. The purposes of having the involvement of this second individual are; to ensure that proper

authority for the transaction or activity has been given, the transaction or activity is properly recorded, and proper settlement is made. Dual control in automated systems should be used in the same manner as in a manual system. Supervisory holds should be placed on customer accounts requiring special attention. For example, dormant accounts, collateral accounts and accounts with large uncollected funds normally have holds that require the action of two people to remove. In addition, certain types of transactions (e.g., master file changes) should require special codes or terminal keys from two people before they can be completed. When a hold on an account is added/removed or when a transaction requiring supervisory approval is completed on an automated system, exception reports will be printed and should be reviewed by a designated person not involved with the transaction. Used conscientiously, automated dual control methods are superior to the manual procedures.

Employee Hiring Procedures - The credit and previous employment references of prospective employees should be checked by management. The facilities of the FBI are available to check the fingerprints of employees and prospective employees of banks and to supply such institutions with criminal records, if any, of those whose fingerprints are submitted. Pursuant to Section 19 of the FDI Act, written consent of the FDIC is needed in order for persons to serve in an insured bank as a director, officer or employee, if they have been convicted of a criminal offense involving dishonesty or breach of trust. Some insurance companies that write bankers' blanket bonds also offer assistance to banks in screening officers and employees.

Emergency Preparedness Plans - Written emergency preparedness plans and off-premise storage of backup files for all critical records should be maintained in the event of natural disaster or physical damage to premises.

Reporting Shortages - Procedures should be developed for the prompt reporting and investigation of shortages when they become known. The results of an investigation should be reported to supervisory personnel within the bank and to fidelity insurers, regulators and law enforcement agencies, when appropriate.

III. AUDIT

All banks should adopt an adequate audit program. Ideally, such a program would consist of a full-time, continuous program of internal audit coupled with a well-planned external auditing program. Such a system would substantially lessen the risk that a bank would not detect potentially serious problems. An external auditing program is a set of procedures designed to test and evaluate the high risk areas of a bank's business. They are performed by an independent auditor who may or may not be a public accountant. A strong internal auditing function establishes the proper control environment and promotes accuracy and efficiency in the bank's operations. While the importance of any bank having an adequate system of internal control cannot be overstressed, examiners should be aware that in many small banks having limited personnel satisfactory auditing programs (both internal and external) are the primary tool for insuring correctness of records and operations. For this reason, examiners should devote appropriate time and attention to analyzing a bank's auditing systems and reports.

External Audit

The FDIC has adopted a Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks and a Statement of Policy Providing Guidance on External Auditing Procedures for State Nonmember Banks. Both statements are included in the Prentice-Hall volumes under FDIC Statements of Policy. The examination reports for banks that are not in general compliance with both policy statements regarding external audits should indicate the status of implementation efforts. When warranted, the examiner's comments and recommendations with respect to the adequacy of a bank's external auditing program should also be presented.

Audit Committees. All banks are strongly encouraged to establish an audit committee consisting, if possible, entirely of outside directors and, in appropriate circumstances, should be criticized for not doing so. Although a committee of outside directors may not appear possible in a small closely-held bank where there are, in effect, no outside directors on the board, all banks should be encouraged to add outside

directors to their board and to appoint them to the audit committee. The audit committee or board should annually analyze the extent of external auditing coverage needed by the bank.

It should also determine whether the bank's needs will best be met by an audit of its financial statements or by an acceptable alternative. When selecting the scope of the planned external auditing program, the committee or board should ensure that the program will provide sufficient substantive external coverage of the bank's risk areas and any other areas of potential concern. If not, additional external auditing procedures by an independent auditor may be appropriate for a specific year or several years to cover particularly high risk areas. The decision resulting from the deliberations of the board or committee should be noted in the minutes. If, in the judgement of the examiner, unique risks of the bank need additional external auditing coverage, specific recommendations for addressing these areas should be made for audit committee and/or board consideration.

These recommendations may include specific procedures from the policy statements or procedures suggested in auditing publications from banking industry trade associations and auditing organizations (e.g., the American Bankers Association's *Guidelines for Community Bank Directors' Examinations* and various Bank Administration Institute auditing publications).

Nevertheless, examiners should not automatically comment negatively on a bank with an otherwise satisfactory external auditing program merely because it does not engage an independent public accountant to perform an audit of its financial statements.

External Audit of the Financial Statements. Each bank is strongly encouraged to adopt an external auditing program that includes an annual audit of its financial statements by an independent public accountant (unless its financial statements are included in the audit of its holding company's consolidated financial statements).

A bank that does so would generally be considered to have satisfied the objectives of both FDIC policy statements. An external audit of a bank's financial statements benefits management by assisting in the establishment of the accounting and operating policies, internal

controls, internal auditing programs, and management information systems necessary to ensure the fair presentation of these statements. An audit also assists the board of directors in fulfilling its fiduciary responsibilities and provides greater assurances that financial reports are accurate and provide adequate disclosure.

Alternative External Auditing Programs. If the audit committee or board, after due consideration, determines not to engage an independent public accountant to conduct an annual audit of the bank's financial statements, the reason(s) for the conclusion to use one of the acceptable alternatives or to have no external auditing program should be documented in the written minutes of the meeting. Generally, the board or committee should consider not only the cost of an annual audit, but also the potential benefits. The examiner should determine whether the alternative selected by the bank (1) adequately covers the high risk areas of that particular bank and (2) is performed by a qualified auditor who is independent of the bank. As with deficiencies in an internal auditing program, any weaknesses in the scope of the bank's external auditing program should be commented on in the examination report.

If a bank chooses not to have an external audit of its financial statements by an independent public accountant, the examiner should strongly encourage the bank, at a minimum, to engage an independent auditor (who need not be an independent public accountant) to perform the recommended basic auditing procedures in the FDIC policy statement. If a bank already has engaged an external auditor to perform an auditing program for the bank and the procedures to be performed do not correspond to or exceed those recommended, the examiner should not automatically comment negatively, but should carefully weigh the reasons for excluding certain procedures against the risks in the bank's business and operations. If procedures have been omitted on the basis of the immateriality of those areas in relation to the bank's total operations, the examiner should assure that this lack of materiality is reviewed annually by the auditor. However, if high risk areas are not adequately covered, the examiner should urge the bank to modify its engagement letter (contract) appropriately, if and to the extent possible. In any case, the examiner should recommend to the bank that the additional procedures listed in the policy

or suggested in banking industry auditing publications be performed in the future and that any other deficiencies in the auditing program be corrected to ensure that there is adequate independent external auditing coverage of the risk areas of the bank's operations.

If a bank has no external auditing program, the examiner should review the minutes to determine the reasons for this choice. A strong internal audit program is fundamental to the safety and soundness of a bank, but it is usually not a sufficient reason for the lack of an external auditing program. One should complement the other, as the external program tests and proves (or disproves) the strength of the internal auditing program. In such situations, the bank should be strongly urged to reconsider its decision.

State-mandated Auditing Requirements. Banks that are governed by state-mandated external auditing requirements which correspond to or exceed those recommended in the FDIC policy statement, including the provisions pertaining to the independence of the auditor, may satisfy this policy by submitting a copy of the auditors' report from the state-mandated external auditing program to the FDIC. Nevertheless, if the examiner determines that unusual risks are present in a bank and that these risks were not adequately addressed by the state-mandated procedures, the examiner should recommend that additional procedures be performed.

If state-mandated external auditing requirements are less rigorous than those recommended in the policy, the bank should be strongly encouraged to supplement its state-mandated procedures with additional procedures so that its external auditing program satisfies the 1990 policy.

External Auditors' Reports. Each state nonmember bank that undergoes any external auditing work, regardless of the scope of the work, is requested to furnish a copy of any reports by the public accountant or other external auditor, including any management letters, to the appropriate FDIC Regional Office as soon as possible after their receipt by the bank. A bank whose external auditing program combines state-mandated requirements with additional recommended procedures may submit a copy of the auditors' report on its state-mandated procedures that is supplemented by a report on the additional procedures. In addition, the FDIC

requests each bank to notify promptly the appropriate Regional Office when any public accountant or other external auditor is initially engaged to perform external auditing procedures and when a change in its accountant or auditor occurs.

The auditors' reports submitted to the FDIC by a financial institution which chooses an alternative external auditing program rather than an annual audit of its financial statements should include the following six items listed in the section, "Auditor's Report to the Bank's Board of Directors," at the end of the policy statement: (1) the accounts or items on which the procedures were applied; (2) the sampling method(s) used; (3) the procedures and agreed-upon extent of testing performed; (4) the accounting basis on which the accounts of items being audited are reported; (5) the auditor's findings; and (6) the date as of which the procedures were performed. If material information is missing, the Regional Office may contact the bank to obtain additional information. For example, the auditor is requested to indicate the procedures performed. If the auditor's report states that the "procedures agreed upon with management" have been performed, the bank should be requested to supply a copy of the engagement letter or other document that outlines the agreed-upon procedures so that the FDIC can determine the scope of the external auditing program.

If they are available, the auditors' reports, including management letters, should be reviewed by the examiner for areas of particular concern when planning the examination. In addition, all correspondence and memoranda between the bank and its auditor concerning the audit or auditing procedures performed (including the auditor's report and management letter if not available in advance) should be reviewed near the beginning of the examination. (Auditor's workpapers are generally considered the property of the auditors and are not likely to be retained on the bank's premises for inspection by examiners). During the examination, the examiner should verify that reports were submitted promptly to the Regional Office and determine the adequacy of the bank's plans to implement the auditor's recommendations. In addition, if the reports were not submitted promptly to the Regional Office, the examiner should seek a commitment from the bank to do so in the future.

Troubled Banks. When examining banks which have not had audits performed by an independent public accountant and at which any of the following conditions exist:

- (a) Internal controls and internal auditing procedures are inadequate;
- (b) The directorate is generally uniformed in the area of internal controls;
- (c) There is evidence of insider abuse;
- (d) There are known or suspected defalcations;
- (e) There is known or suspected criminal activity;
- (f) It is probable that director liability for losses exists;
- (g) Direct verification is warranted; and/or
- (h) Questionable transactions with affiliates have occurred,

the examiner and Regional Office staff should consider adding to any contemplated administrative order a condition directing the bank to obtain an audit or, if more appropriate, to have the specified auditing procedures in the policy statement performed by a public accountant or other independent party. Since each situation differs, the examiner and Regional Office must evaluate the type of external auditing program that would be most suitable for each troubled bank and, in conjunction with Regional Counsel, ascertain that the inclusion of such an external auditing program as a condition in the order is appropriate. Whenever a condition requiring an audit or specified auditing procedures is included in an order, it should include requirements that the bank promptly submit copies of the auditor's reports to the Regional Office and notify the Regional Office in advance of any meeting between the bank and its auditors at which auditing findings are to be presented.

Communication with External Auditors

An interagency policy statement on coordination and communication between external auditors and examiners has been issued. This statement of policy includes guidelines regarding meetings between

external auditors and examiners.

The FDIC encourages communication between its examiners and external auditors with the permission of an institution's management. Permission has been given once an institution notifies the FDIC of the name of the accountant or accounting firm that it has engaged as its external auditor (by letter or by submitting a copy of its auditors report to an FDIC Regional Office). Permission continues until the institution notifies the FDIC that its relationship with the external auditor has been terminated or that another auditor has been engaged.

The FDIC encourages external auditors to attend exit conferences and other meetings at which examination findings are discussed between an institution's management and its examiners. In addition, auditors may request a meeting to discuss relevant supervisory matters with any of the regulatory agencies involved in the institution's supervision. An auditor who determines that communication with the FDIC is warranted concerning a recent examination should contact the appropriate Regional Office. A Regional Office staff member, the examiner, or the field office supervisor may discuss any of the examiner's findings with the external auditor. The regulatory agencies will usually request that management of the institution be represented at the meeting. However, an external auditor may request a meeting without the representation of the institution's management.

Requests for meetings and information can also originate with the regulatory agencies. If questions arise concerning matters pertaining to the institution on which the external auditor is knowledgeable, examiners may request meetings, including confidential meetings, with an institution's external auditor. FDIC staff may also inquire of the external auditor whether any problems of which the FDIC should be aware have been encountered during the audit of the institution. Furthermore, copies of workpapers relating to services performed by the external auditor may be solicited. In some instances, an FDIC examiner, field officer supervisor, or Regional Office staff member may determine that attending the meeting between an institution's auditors and its management or board of directors (or an appropriate committee) at which the audit report is discussed would be useful. The institution should be advised and asked to present the request to the auditor.

The interagency policy statement on coordination and communication between external auditors and examiners also suggests that a depository institution

provide its external auditor a copy of certain regulatory reports and supervisory documents including, but not limited to, reports of condition, examination reports and correspondence from regulators, any memorandum of understanding or written agreement, and a report on any actions initiated under Section 8 of the FDI Act or similar action taken by a state banking supervisor.

Similarly, an AICPA statement of position stresses communication between auditors and examiners. For example, the statement of position recommends that auditors endeavor to be responsive to any requests from examiners to attend meetings with an institution's management at which audit reports are reviewed. The statement of policy also suggests that an independent auditor review examination reports and related communications between examiners and the financial institution. It also directs that auditors should, in appropriate situations, make inquiries of examiners. According to the AICPA's statement of position, a refusal by management of the financial institution to allow the auditor to review such material or to communicate with the examiner would ordinarily be a limitation on the scope of the audit sufficient to prevent the auditor from rendering an opinion.

Internal Audit

Perhaps the most effective internal control procedure available to a bank's board of directors is the appointment of a professionally competent internal auditor responsible for the development and administration of an internal audit program. The basic purpose of internal auditing is the prevention and detection of loss. An effective program would include determination that controls and operational procedures are functioning in a manner that would minimize the possibility of losses due to inefficiencies, irregularities and/or willful manipulation. The auditor's role is to help safeguard the bank's assets by performing tests and procedures establishing the validity and reliability of operating systems, procedural controls and resulting records. The internal audit program should be in written form, be approved by the bank's audit committee or board of directors, identify the scope of the program, be reviewed on a periodic basis, and be revised when necessary. Auditors must have complete independence in carrying out the audit program and should report

their findings directly to the bank's board of directors or a designated directors' audit committee. It is imperative that internal auditors have sufficient authority and the degree of audit independence essential to exercise their responsibilities, and that they be divorced from operations.

A comprehensive internal audit program should include the following elements.

1. A determination that the records of the bank are complete and adequate, and that transactions are promptly and properly recorded in the accounts.
2. If the bank's records are processed by an EDP servicer, a review of data controls. These should include proof totals, batch totals, document counts, number of accounts, and prenumbered documents that occur at the institution prior to submission to the servicer. The controls should be periodically sampled by the auditor to ensure their accuracy. Sampling includes spot checking reconciliation procedures to ensure output totals agree with input totals; reviewing the disposition of rejected, unpostable, holdover, and suspense items, determining why they are unprocessable, and assuring that they are properly corrected and reentered on a timely basis; and verifying selected master file information and reviewing exception reports, such as service charge codes and loan extensions to source documents.
3. A determination that assets are adequately safeguarded and properly presented in financial reports, and that liabilities are completely disclosed and accounted for.
4. An assurance that collateral and other nonledger items are properly recorded and protected by effective custodial controls.
5. A check for compliance with applicable statutes and regulations.
6. A review for compliance with policies set forth by management and/or the board of directors, including verification that loans and securities have been properly approved. This would also encompass such matters as review of EDP processing procedures and controls, as well as reviewing source documents to ensure that sensitive master file change requests have supervisory approval.
7. An accounting for the receipt of income and review of expenses to determine that they are authorized, correct in amount, and consistent with bank policy. This would also include spot checking computer calculations, such as loan rebates, interest on deposits, late charges, service charges, and past-due loans to ensure they are accurate.
8. An appraisal of the performance of personnel in accomplishing assigned internal control functions and responsibilities. This would entail tracing transactions to final disposition to ensure there are adequate audit trails.
9. A validation of the authority granted to members of the organization (to make loans or sign official checks, bank drafts, internal entries, letters of authorization, deeds, transfers, and any other types of legal or accounting documents) to be certain there are no departures from established policy.
10. A review of loan losses, operating chargeoffs, and the control exercised over recoveries.
11. An evaluation of the adequacy of fidelity and casualty insurance in force.
12. The preparation of a proper and complete set of working papers covering each audit.
13. The utilization of accepted verification and confirmation techniques.
14. The establishment and maintenance of an operating manual describing the specific procedures and techniques to be used by the auditor or auditing staff in performing the audit function.
15. A direct verification of loan and deposit balances on a periodic basis.

It is recognized that a full-time internal auditor or auditing staff is economically impractical for many small banks, however, an internal audit program

for these institutions is entirely feasible. Various National and State banking associations have prepared written instructions for programs of continuous audits that can be administered by even a small bank's staff. In essence, these programs provide for auditing of accounts by individuals who have no responsibility for them.

Part 363 of the FDIC Rules and Regulations

Although the described audit programs are recommended for all depository institutions in accordance with general prudent banking practices, certain institutions are specifically required by law to have audit programs. Part 363 of the FDIC Rules and Regulations establishes audit and reporting requirements for insured depository institutions with total assets of \$500 million or more and their independent public accountants.

Management of each institution covered by this regulation must

- engage an independent public accountant,
- prepare annual financial statements in accordance with generally accepted accounting principles, and
- produce annual reports.

These annual management reports must contain a statement of management's responsibilities for preparing the financial statements, for establishing and maintaining an internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to loans to insiders and dividend restrictions. The reports must also contain an evaluation by management of the effectiveness of the internal control structure and procedures for financial reporting and an assessment of the institution's compliance with designated laws and regulations.

The independent public accountant engaged by the institution is responsible for

- auditing and reporting on the institution's annual financial statements in accordance with generally accepted auditing standards;
- examining, attesting to, and reporting separately on the assertions of management concerning the institution's internal control structure and procedures for financial reporting; and
- determining compliance by the institution with designated laws and regulations.

Reporting Requirements - Part 363 requires that

insured depository institutions submit the following reports and notifications to the FDIC, the appropriate federal banking agency, and the appropriate state bank supervisor.

- *Within 90 days after fiscal year end, an annual report must be filed. The annual report must contain audited annual financial statements, the independent public accountant's audit report, management's statements and assessments, and the independent public accountant's attestation concerning the institution's internal control structure and procedures for financial reporting.*
- *Also within 90 days of the institution's fiscal year end, the accountant's attestation regarding compliance with laws and regulations regarding loans to insiders and dividend restrictions must be sent.*
- **Within 15 days after receipt, the institution must submit any management letter; the audit report and any qualification to the audit report; and any other report, including attestation reports, from the independent public accountant.**
- **Within 15 days of occurrence, the institution must provide written notice of the engagement of an independent public accountant, the resignation or dismissal of a previously engaged accountant, and the reasons for such an event.**

Part 363 requires certain filings from independent public accountants. The accountants must notify the FDIC and the appropriate federal banking supervisor when it ceases to be the accountant for an insured depository institution. The notification must be in writing, must be filed within 15 days after the relationship is terminated, and must contain the reasons for the termination. The accountant must also file a peer review report with the FDIC within 15 days of receiving the report or before commencing any audit under Part 363.

Audit Committee - Each insured depository institution subject to Part 363 must establish an independent audit committee of its board of directors. The members of this committee must be outside directors who are independent of management. Their duties include overseeing the internal audit function, selecting the accountant,

and reviewing with management and the accountant the scope of the audit, the audit conclusions, and the various management assertions and accountant attestations.

Part 363 establishes the following additional requirements for audit committees of insured depository institutions with total assets of more than \$3 billion: two members of the audit committee must have banking or related financial management expertise; large customers of the institution are excluded from the audit committee; and the audit committee must have access to its own outside counsel.

Holding Company Subsidiary Institutions

Subsidiaries of holding companies, regardless of asset size, may file consolidated financial statements of the holding company in lieu of separate financial statements. If the subsidiary has \$5 billion or more in total assets and a CAMEL rating of 1 or 2, and its holding company performs services and functions comparable to those required by the statute, it may rely on the holding company's audit committee and may file a management report and accountant's attestations that have been prepared for the holding company. If the institution is a subsidiary of a holding company and has \$5 billion or more in total assets with a composite CAMEL rating of 3, 4 or 5, it may file the audited consolidated financial statements of the holding company. However, the institution must have its own audit committee and file a separate management report and accountant's attestations.

The institution's audit committee may be composed of the same persons as the holding company's audit committee only if such persons are outside directors of both the holding company and the subsidiary and are independent of management of both. A separate set of minutes must be maintained.

If the institution being examined is not the lead bank in the holding company, the examiner need only confirm that the institution qualified for, and has invoked, the holding company exemption and review the holding company reports to see if they disclose any pertinent information about the institution.

Mergers

Institutions subject to this statute which cease to exist at fiscal year end have no responsibility under this rule. If a covered institution no longer exists as a separate entity as a result of its merger into another

institution after the end of the fiscal year, but before its annual and other reports must be filed under this rule, reports should still be submitted to the FDIC and appropriate federal and state banking agencies. An institution should consult with its primary federal regulator concerning the statements and reports that would be appropriate to submit under the circumstances.

Examination Procedures - Part 363

The contents of audit reports should be considered in establishing the appropriate timing and scope of examinations of institutions. Further, regional office review memoranda, forwarded to the field office with the audit reports, should be reviewed for possible follow-up action or necessary changes to the supervisory strategy. During the examination, the examiner should verify that all necessary reports have been filed with the agencies and that the audit committee is structured to comply with the regulation.

When reviewing the audit report, particular note should be taken of any qualifications in the independent accountant's opinion and any unusual transactions. In reviewing management's report and the accountant's attestations, special attention should be given to any assessment in which management indicates less than reasonable assurance that internal controls over financial reporting are effective or less than material compliance with the designated laws and regulations was found. Notices referencing a change in accountants should be reviewed for possible "opinion shopping" and any other issues that may be related to safety and soundness.

Records maintained by management to support its annual assertions concerning the effectiveness of internal controls over financial reporting and compliance with designated laws and regulations should be reviewed for sufficiency and content. Although a management letter to the institution from the accountant is not required, the examiner should investigate and make appropriate note in the examination report of any situation in which the accountant does not provide a management letter in the current year, when such letters have been regularly provided in previous years.

The examiner should review the minutes of the audit committee to confirm that the committee reviewed the basis for the annual report with management and the independent public accountant. If the internal audit staff performed the agreed upon procedures in Section

I of Schedule A to Appendix A of the guidelines, the examiner should verify that the internal auditor's findings and any exceptions noted were presented to the audit committee. The examination report should note any material problems discerned by the internal auditor in this area that have not been corrected along with the examiner's recommendations for corrective action.

The board's annual determination that all members of the committee are "independent of the management of the institution" should also be reviewed. For institutions exceeding \$3 billion in total assets, the examiner should review board determinations and minute documentation that at least two members of the audit committee have banking or related financial management expertise and that no member is a large customer of the institution. Appropriate recommendations should be made in the examination report if any determination is judged as unreasonable.

At the first examination of each institution subject to Part 363, examiners should describe and discuss any apparent violations, but based on their judgment of the institution's situation, should focus on education and making recommendations about compliance. The examination report should indicate the status of the institution's implementation efforts if not yet in full compliance with the rule. Specific comment, or criticism of an institution's policies and practices may be recorded on the Administration, Supervision and Control page 8, item 6 in the examination report. Noncompliance with the requirements of Part 363 warrants a negative response to the SAER item which asks if adequate written audit policies exist and are followed.

Problems or concerns with the accountant's or firms's auditing, attestation, or accounting policies and procedures that may represent a basis for a suggested review of its peer review workpapers should be referred to the Registration and Disclosure Section in the Washington Office. This referral does not preclude the regional office from filing a complaint, or taking any other enforcement action, against the accountant.

Examiners, if requested, are not to provide any written representations concerning Part 363 to institutions or their independent outside auditors. Examination staff should continue to respond orally to inquiries of external auditors in accordance with outstanding guidelines on these communications.

Workpaper Review Procedures

Examiners, in consultation with the regional accounting specialist, may review the workpapers of the independent public accountant. Workpapers of the holding company audit may be examined with regard to the examination of a subsidiary institution. However, before any workpaper review is undertaken, the primary federal regulator and any state bank supervisors of the institution or other holding company subsidiaries should be contacted to arrange a coordinated review. No set of workpapers should be reviewed more than once by all concerned agencies combined.

A review of workpapers is not expected to be performed for every covered institution, but examiners should review the workpapers for a sample of institutions. A workpaper review may help determine the scope of the examination by identifying those areas where sufficient audit work was performed by the independent public accountant so examination procedures could be limited, and those areas of higher risk on which examination procedures should be expended. A workpaper review may be especially useful before or during an examination if the institution has asset quality problems, aggressive accounting practices, mortgage servicing activities, or large deferred tax assets.

Requests by the Regional Director to independent public accountants for access to workpapers should be in writing and specify the institution to be reviewed, indicate that the accountant's related policies and procedures should be available for review, and request that a staff member knowledgeable about the institution be available for any questions. Since workpapers are often voluminous, examiners are expected to view them where they are located. Since these workpapers are highly confidential, examiners are encouraged to take notes of needed information, and should request copies of only those workpapers that are needed for their records. No requests for copies of all workpapers should be made.

Complaints Against Accountants

An examiner encountering evidence of possible violations of professional standards by a CPA or licensed public accountant should, if practicable, initially discuss the matter with the accountant in an attempt to resolve the concern. If the concern is not resolved in this manner, the examiner should send a memorandum to the Regional Director summarizing the evidence of possible violations of professional

standards and the inability to resolve the matter with the accountant. As part of the discussion, the accountant should be made aware that a complaint to the AICPA and/or the state board of accountancy is under consideration. Documentary evidence should be attached to support comments. Where notification of apparent violation of professional standards appears appropriate, letters should be concurrently forwarded by the Regional Director to the state board of accountancy in the institution's home state, the Professional Ethics Division of the AICPA (in the case of certified public accountants), the subject accountant or firm, and the DOS Accounting Section in Washington.

In addition to violations of professional standards, complaints should also include substandard auditing work or lack of independence.

Specific Review of Audit Systems and Reports

The examiner's evaluation of internal/external audit procedures and reports plays a key role in the overall assessment of a bank's internal controls system. The following is a listing of functions and procedures that should be encompassed by the audit program. The list is not all-inclusive and lack of performance in any one area should not necessarily be viewed as a major deficiency. The list may, however, serve as a framework to assist in the evaluation of a bank's audit program.

Cash Accounts - Verify cash on hand; review cash items, cutbacks, or any other assets or liabilities held in suspense accounts to determine proper and timely disposition; and verify clearings.

Due From Banks - Test and review bank prepared reconcilements, with particular emphasis on old or recurring outstanding items; obtain cut-off bank statements as of audit date and an appropriate date subsequent thereto for use in testing bank reconcilements; review all return items for an appropriate period subsequent to the audit date; and confirm balances due from banks to include time accounts with the banks holding the deposits.

Investments - Prove subsidiary records to the general ledger; verify securities on hand or held by others for safekeeping; check the gain and loss entries on securities sold or matured since the previous audit; review accrued interest accounts and test check computations and disposition of

interest income.

Loans - Prove subsidiary records to general ledger; verify a sampling of loan balances on a positive or negative basis; verify the existence of negotiable collateral; review accrued interest accounts and test the computation and disposition of interest income; verify leases and related balance sheet accounts; verify unearned discount account; and test rebate amounts for loans that have been prepaid.

Allowance For Loan Losses - Verify loan balances for loans charged-off since the previous audit and the debit entries to the allowance account; check supporting documentation for loans charged-off; and review loan recoveries and check the credit entries in the allowance account.

Bank Premises and Equipment - Examine entries and documentation relative to purchases and sales since the previous audit; check computation of depreciation expense; and check computation of gain or loss on property sold and trace sales proceeds.

Other Assets - Verify the appropriateness of all other asset categories.

Deposits - Reconcile subsidiary records to general ledger accounts; verify account balances on a test basis; review closed accounts and determine they were properly closed; review account activity in dormant accounts and in the accounts of bank insiders; review overdrafts; check computation of service charges and trace postings to appropriate income accounts; review accrued interest accounts and check computation of interest expense; account for numerical sequence of prenumbered certificates of deposit and official checks; reconcile outstanding official checks; determine the validity of outstanding official checks; examine documentation supporting paid official checks; and test certified checks to customers' collected funds balances.

Borrowed Funds - Verify borrowed fund balances; verify changes in capital notes outstanding; and review the accrued interest accounts and check computation of interest expense.

Other Liabilities - Check the appropriateness of all other liabilities.

Capital Accounts and Dividends - Account for all

unissued stock certificates; review capital account changes since the previous audit; check computations for dividends paid or accrued; and review minutes to determine propriety of dividend payments and accruals.

Consigned Items and Other Non-Ledger Control Accounts - Test rental income for safe deposit boxes; examine and confirm safekeeping items; and reconcile consigned items on hand.

Income and Expenses - Test income and expenses by examining supporting documentation for authenticity and proper approval; and test accruals by either recomputing amounts or examining documents supporting such accruals.

Direct Verification

Direct verification is universally recognized as one of the most effective methods of confirming the correctness and validity of certain accounts, primarily loan and deposit balances and collateral. Direct verification should be an important part of any internal and/or external audit program, and may be employed alone as an internal control separate from regularly scheduled audits.

There are two well-recognized types of direct verification, positive and negative. When the positive method is used, the customer is asked to confirm whether or not the balance, as shown, is correct.

When the negative method is used, a reply is not requested unless an exception is noted. The positive method has obvious advantages from an audit standpoint as it provides considerable assurance the customer has carefully checked the confirmation form. The negative method is less costly and provides a measure of protection in those institutions having a strong program of internal control. The positive method is recommended for loan accounts and preferred for deposit accounts, but because of the high volume and cost factor in the latter, the negative method is often employed. It is suggested that at least large accounts, public accounts, dormant accounts and accounts with high and usual volumes of activity be positively verified.

Direct verification may be conducted in whole or in part. The necessity for a complete verification of loans and deposits is rare. A partial verification of representative accounts is usually satisfactory.

Overdue loans should be included in the verification as well as charged-off loans. It should be noted that direct verification may be accomplished internally as well as externally. To be effective, the verification procedure (including follow-ups) must be completely controlled by someone not having responsibility for the accounts or records being verified.

IV. THE EXAMINER'S RESPONSIBILITIES

Examinations are not undertaken for the detection of fraud, nor is their sole or primary purpose to assure the complete correctness or appropriateness of records. The overall assessment of a bank's system of internal control is, however, an important examination function. In most cases, such an appraisal can be accomplished by an overall evaluation of the internal control system, a specific review of audit systems and reports, performance of standard examination procedures, and recommendations to management. In some instances, all or a portion of a bank's system of internal control may be deficient, or management or the condition of a particular institution may be such that more intensive audit tests, suited to the particular circumstances and needs of the bank under examination, should be undertaken. These matters are discussed in a following section on possible audit techniques.

These techniques may lead to an indication of possible fraud or insider abuse. Such situations should be thoroughly investigated by the examiner. Please refer to the Bank Fraud and Insider Abuse Section of this Manual for further information.

Overall Evaluation of Internal Controls

The Internal Routine and Controls (Workpaper) schedule provides a framework for an overall evaluation of a bank's system of internal controls. The form is designed to highlight any deficiencies that may exist. It is not considered to be an all-inclusive coverage of every aspect of internal control and is in no way intended to limit criticisms and recommendations relating to other operational practices. The examiner's principal efforts should be focused on the detection, exposure and correction of important weaknesses in the bank's records, operating systems, and

auditing procedures. Information should be developed through discussions with management and employees and examiner observation of performance and procedures. Each bank presents specific situations to which common sense and technical knowledge must be applied. The size of the institution, the number of employees and the character of the bank's operations must be considered in any meaningful evaluation.

Standard Examination Procedures

Performance of certain standard examination procedures is a means by which an assessment of the bank's internal control program may be facilitated (see list below). These procedures are not necessarily designed for the exclusive purpose of evaluating the internal control environment. In many cases, the principal objective of a particular examination procedure is to ascertain any adverse safety and soundness implications of the activity. For example, review of securities purchases and sales is usually prompted more by a concern over possibly unfavorable earnings or liquidity consequences than the control of purchase and sale activity itself. As the examiner undertakes these standard examination steps, an assessment of the bank's controls relating to those areas is usually possible.

1. **Cash Items** - Review cash items and return and/or suspense items as of the asset review date. Subsequent review should be accorded to determine proper disposition. Particular attention should be given to any item of insiders of the bank under examination, insiders of other banks, or of public accounts where insiders act as custodians (e.g., the cashier of the bank is treasurer of the local school district). If deemed necessary, cash items lists prior to the examination date should be reviewed for impropriety.
2. **Due From Banks** - Determine procedures utilized by the bank in reconciling due from bank accounts. If internal control procedures are considered adequate, review the most recent bank-prepared reconcilements for any unusual items and determine that closing balances agree with the appropriate general ledger account. If internal control procedures are deemed inadequate, prepare reconciliation(s) of at least the major due from banks account(s). Investigate any items which are large or unusual or have been outstanding for any undue period of time in order to determine appropriate disposition, including the possibility of charge-off.
3. **Securities** - Review purchases and sales since the previous examination and determine if (a) the volume of trading in the account is reasonable in relation to the size and condition of the bank; (b) significant changes have occurred in the maturity schedule; (c) a significant shift has occurred in the type or quality of the holdings; and (d) purchases and sales are in accordance with bank policy. Update information on any speculative or defaulted issues for inclusion in the appropriate report schedules. Obtain current market prices for all speculative or defaulted issues. In the case of all other issues, utilize the bank's pricing if available (and the price list is dated within 30 days from the examination as of date), there has been no significant change in the portfolio since the date of pricing, and if there is no evidence of significant change in market values since the date of pricing. If the bank's pricing list is older than 30 days or if such a list is not available, obtain current market values for U.S. Government and Federal Agency securities. Obtain market prices for other security issues except State, county and municipal securities, which should be estimated at book value but for which the most current rating should be obtained. Regarding issues purchased and sold since the previous examination, spot check for proper handling of accrued interest purchased, premium amortization, discount accretion, and accounting for purchases and sales.
4. **Premises and Equipment** - Spot check entries made since the previous examination for adequacy of depreciation and appropriate accounting for purchases and sales.
5. **Other Assets** - Review subsidiary records for large amounts, appropriate handling, and necessity for adverse classification, if any.
6. **Income Accruals** - Check for removal of nonearning assets from the accrual base. The degree of examiner review is dictated by

management familiarity with the accrual system, internal review procedures, and the degree to which these accounts are analyzed during audits.

7. **Deposit Accounts** - Review reports or records pertaining to overdrafts, large items and uncollected funds for possible "check kiting" or other irregular activity. Particular attention should be directed to overdrafts of bank insiders or insiders of other banks. Deposit accounts of directors, officers, employees and their interests should be reviewed for impropriety or violation of law.
8. **Other Liabilities** - Review subsidiary records for large amounts and appropriate handling.
9. **Expense Accruals** - The degree of examiner review is dictated by management familiarity with the accrual system, internal review procedures, and the degree to which these accounts are analyzed during audits.
10. **Capital Accounts and Earnings** - Review stock ledgers for significant ownership changes, especially changes that might be subject to the reporting requirement of the Change in Bank Control Act. Scan expense accounts for any large or unusual expenditures, possible illegal payments, and reasonableness of any management fees, dividends, and other types of extractions by insiders. Review contingent liabilities for any adverse effects on the bank's capital position.
11. **Insurance** - Review primary and excess fidelity coverage to determine the adequacy of each and whether or not insurance remains in force.
12. **Board and Committee Minutes** - Review Board and Committee minutes since the last examination to determine that proper supervision is being accorded, including the review and approval requirements on insider loans pursuant to Federal Reserve Regulation O.
13. **Internal Controls** - Prepare the Internal Routine and Controls (Workpaper) schedule for inclusion in the examination workpapers. Examiners should detail serious deficiencies on the supplemental Internal Routine and

Controls schedule. Review procedures and reports that were prepared as a result of internal audits and, if applicable, determine whether or not noted deficiencies have been corrected. Review the last external audit report and management letter to determine their adequacy and if reported deficiencies have been corrected.

14. **General** - Confirm by positive verification the following: loan participations purchased and sold since the previous examination; securities held for safekeeping; and any transactions with correspondent banks, such as excess funds purchased and sold and time certificates of deposit. In banks where records are computer generated, subsidiary totals should be balanced to the general ledger and reconciling amounts, if any, satisfactorily explained and cleared. However, for those banks with manual accounting systems and adequate internal controls, examiners need not prepare proof tapes of individual deposit and loan ledgers.

Recommendations to Management or the Board of Directors

Serious or numerous internal routine and controls deficiencies detected during an examination should be brought to management's and the board's attention and appropriate action urged. In making recommendations and criticisms, examiners should consider the following points.

1. The advantage and profitability of the suggestion to the bank should be stressed, not the advantage to the examiner.
2. The suggestion or criticism must have substance and merit; criticisms that might be regarded as petty or reflect personal preference of the examiner will not be well received.
3. The recommendation or criticism should be discussed with operating management prior to bringing it to the attention of the bank's board of directors. The record or procedure being criticized may have been devised by the banker who may have considerable pride in it and, conceivably, can offer a persuasive reason for its continuance.
4. Recommending records or accounting forms

supplied by a particular stationery house is to be avoided. These decisions are within the purview of bank management, not examiners.

5. It is possible to overdo criticisms. The goal of obtaining correction of major deficiencies, as opposed to listing a volume of relatively minor criticisms, is more desirable.
6. The best results are achieved when criticisms are based on specific negative findings, rather than generalities, and accompanied by recommended remedial action consistent with the seriousness of the deficiencies and the bank's capacity and needs. However, the relative importance of an individual control or lack thereof must be viewed in the context of the other offsetting control procedures that may be in place. When deficiencies are considered to be of sufficient importance, appropriate comments should be set forth on the Examination Conclusions and Comments schedule.

Fraud and Insider Abuse

While examinations are not undertaken for the purpose of uncovering fraud, the examiner must be alert to its possible existence. Fraud has been committed by bank personnel at every level and large defalcations have been perpetrated over a period of years by experienced officers and employees. The following represent some of the most frequently used methods of manipulation, as applied to those accounts which normally offer the greatest risk and vulnerability. In addition, the Bank Fraud and Insider Abuse Section of this Manual contains a surveillance module for detecting bank fraud and insider abuse.

Loans - Forged or fictitious notes; accommodation loans; loans to insider-related shell companies; embezzlement of principal and interest payments; failure to cancel paid notes; use of blank, signed notes; embezzlement of escrow and collection accounts; commissions and kickbacks on loans; fraudulent loans to cover cash items and overdrafts; and diverted recoveries of charged-off loans.

Loan Collateral - Loans secured by phony collateral such as altered, stolen, or

counterfeit securities; or certificates of deposit issued by illegitimate off-shore banks. Brokered loans and link financing arrangements where underlying collateral is not properly pledged or is prematurely released.

Deposits - Unauthorized withdrawals from dormant accounts; fictitious charges to customer accounts; unauthorized overdrafts; payment of checks of bank personnel against customer accounts or against fictitious accounts, manipulation of bookkeepers' throw-out items, computer rejects or other items needed to reconcile deposit trial balances; unauthorized withdrawals from accounts where the employee is acting as an agent or in some other fiduciary capacity; withholding and destroying deposit tickets and checks; misappropriation of service charges; kiting; and manipulation of certificates of deposit, official checks, and money orders.

Correspondent Bank Accounts - Lapping of cash letters; delayed remittance of cash letters; fictitious credits and debits; issuing of drafts without corresponding recordation on the bank's books or credit to the account; overstatement of cash letters and return items; and false collection items.

Tellers and Cash - Lapping deposits; theft of cash; excessive over and short activity; fraudulent checks drawn on customers' accounts; fictitious cash items; manipulation of cash items; and intentional failure to report large currency transactions.

Income and Expense - Embezzlement of income; fraudulent rebates on loan interest; fictitious expense charges; overstated expense; and misapplication of credit life insurance premiums.

Bond Trading - Adjusted trading, which usually involves collusion between a bank employee and a securities dealer to trade securities at inflated prices; concealing trading losses from bank management and examiners; and unauthorized purchases and sales of securities, futures, or GNMA forward contracts with benefit accruing to a bank employee.

The different types of manipulations employed in defalcations appear to be limited only by human ingenuity and innovativeness. The schemes and methods devised to cheat banks are virtually unlimited and pose a continuing problem to banks and examiners alike. While no bank is exempt from the threat of defalcations by management, employees or outsiders, certain institutions are more vulnerable than others. Any one or more of the following conditions or situations may be indicative of the need to utilize more comprehensive and intensive audit techniques:

1. The one-person dominated or operated institution wherein one officer has complete control over a bank's operations;
2. Lack of any audit program;
3. Weak internal controls such as deficient vacation policies or lack of separation of duties;
4. The institution in which records are poorly maintained and carelessly handled;
5. Banks in which close supervision by the board of directors and/or senior management is lacking, especially where rapid growth has occurred with concomitant accession of inexperienced management;
6. Banks which have recorded substantial growth in a short period of time. This may reflect the employment of "hot" money or brokered funds, combined with fraudulent or poor quality loans, resulting in dishonest acts to conceal the bank's true condition;
7. Banks which have recorded little growth or a steady decline in deposits despite general economic prosperity in their operating area and continued growth by competing institutions;
8. Banks in which earnings and yields are below average and expenses are high in comparison with past operating periods with no apparent explanation for the change; and
9. Banks with abnormal fluctuations in individual revenue or expense accounts either in terms of dollar amounts or in relation to all other operating accounts.

Possible Audit Techniques

Because of the virtually limitless opportunities for perpetrating and concealing fraud in banks, even a complete and comprehensive audit may not expose the commission of deceptive practices. Constraints of time and optimum utilization of resources do not permit a complete audit during bank examinations, nor would the benefits derived from such efforts generally be warranted. Nevertheless, in those cases where the examiner perceives the need, the examination may be expanded to include the use of more audit techniques and procedures. The following is a listing of certain audit techniques available to examiners. The list is not all-inclusive, nor is it intended that any or all of these procedures be utilized at every examination.

General - Examiner-prepared reconcilements of all asset and liability items can ensure that individual subsidiary records balance to general ledger controls. Performance of any or all of the checks, test and reviews listed in this section of the Manual under "Specific Review of Audit System and Reports" may also be helpful. Finally, utilization of examiner EDP support programs and packages may be very useful. These were developed to provide examiners with an independent proof of the bank's computerized files.

Direct Verification - Except for the bank's securities, correspondent bank accounts and loan participations, direct verification is an audit procedure not often employed by examiners. However, the examiner may in certain circumstances, after obtaining the approval of the Regional Director, conduct a direct verification of loans and/or deposits. The following basic procedures or guidelines are utilized in direct verification.

1. Addressing, stuffing, sealing and mailing of envelopes should be done by examination personnel only.
2. Franked envelopes furnished for reply should be preaddressed to a post office box rented for that purpose, the Field Office, or the Regional Office.
3. A duplicate record of all items verified should be maintained for control purposes.

4. Watch for borrowers with common addresses or post office box numbers and for accounts having the same addresses as bank officers and employees.
5. Loan verification should include charged-off notes; separate notices should be sent to primary obligors, comakers, endorsers, or guarantors.
6. Third party guarantees on lines of credit or individual notes should be verified directly with guarantors and not through primary obligors.
7. Deposit verification of recently closed dormant accounts, overdrawn accounts and pledged accounts should be included.
8. All replies should be compared against retained duplicate records. Exceptions should be further investigated against bank records or through follow-up correspondence with customers until discrepancies are satisfactorily resolved.
9. Undelivered and returned tracers, unacknowledged verifications, and unexplained differences should be discussed with the entire board, not just with officers.
5. Audit the interest collected on a sampling of loans. Test check the loan interest account for several days and compare the total with journal figures and amount credited to the general ledger.
6. Compare collateral records to loans secured by such collateral, and compare dates as to receipt of collateral with date the loan was granted.
7. In banks having large or numerous loan charge-offs, compare actual charge-offs to those approved by the appropriate authority; confirm that the amount charged-off was the actual balance due on the loan; determine who prepares the list of charge-offs, who collects recoveries, and the accuracy of the reporting of these items; and compare the actual instrument with the bank's records to confirm balances and signatures. Tracing the proceeds of loans charged off should also be considered. Where sizeable loan losses have occurred, it may be advisable to analyze the lines of credit involved by tracing disbursement of loan proceeds and reviewing the borrower's deposit account for possible payments of commissions or fees to a bank officer.

Loans - The techniques suggested below may be valuable when examiners have cause to suspect possible irregularities involving the loan portfolio.

1. Compare the signature on a note with other notes or documents signed by the maker.
2. Determine by review of bank records who actually pays the interest and principal on large lines of continuous credit, and the sources of funds.
3. Regarding weak lines of a continuous nature, investigate the possibility that directors or management are actually the interested party although the bank's records may fail to indicate such information.
4. If a large number and amount of out-of-territory loans are carried, spot check a cross section of these items as to disbursement of loan proceeds and sources of payment of principal and interest.
8. In investigating installment loan departments, the following possible activities should be considered: (a) The "lapping" of payments (use of prior payments which have been withheld to-make current payments on a specific loan(s)) is sometimes encountered. Check installment loan records for an unusually large number of advance payments and/or a sizeable number of overdue loans. In suspect cases, spot check payments made or due to borrowers' checking accounts. (b) Where the volume of total outstanding installment loans has increased substantially between examinations for no apparent reason and overdue loans are unusually low or high, spot check a cross section of loans as to disposition of proceeds, signatures, collateral and sources of payment. In cases of fraudulent credits, loan payments may be traced directly to proceeds of other loans. Be watchful for multiple payments made on the same date on a particular note and compare the total of these payments with new loans granted on the same date. (c) Poorly

handled indirect dealer paper lines should be investigated. Test checks should be made for possible lapping of payments, creation of fraudulent notes to cover delinquent payments, and unauthorized use of the dealer reserve accounts.

Deposits - The following suggestions may be useful in the investigation of improper activities in the bank's deposit accounts.

1. In those banks manually posting deposit records, scan ledgers for perfect alignment of figures and similar ink density. This may indicate the sheet was prepared in one operation to conceal a shortage. Check any changes made in handwriting or by typewriter. Comparison of the balances of transferred sheets with end-of-month statements and pick-up balances on carry forward sheets may prove helpful in suspect situations.
2. Be alert for possible "kiting" in accounts. The characteristics of this type of account usually include large, even checks, deposits of a like or similar amount, and small average balances. The important facts to determine in such cases are the amount of "float", sources of funds, other banks involved and to what extent, and how, when, and under what circumstances the activity began. Computer generated kiting suspect reports or uncollected funds reports can be helpful and should be reviewed.
3. Note any unusual withdrawals from inactive or dormant accounts.
4. Take note of packages of unposted checks and undelivered or returned customer statements.
5. In connection with savings accounts, various means of checking are available to determine the presence or disposition of accounts to which interest was credited on the last interest payment date.
6. Particularly in small banks that lack adequate separation and rotation of duties, the transferring of a shortage between individual deposit accounts is always a possibility. In a bank where deposit transactions are computer posted, such a situation may be

reflected in a machine reject of a continuous and constant amount. In banks with a manual posting system, a comparison of ledger sheets to customer statements for consistency of entries may prove helpful.

7. Cash items, machine rejects and cutbacks should be compared to individual account records to determine if the accounts have been closed, do not exist, or balances are insufficient.
8. Interest paid on certificates of deposit can be cross-checked to the interest expense account as to date, amount due, and amount actually paid.
9. Gain control of incoming cash letters and local clearings. Sight-post items to demand account records to determine if there is an account for each item. If the cash letter has been opened prior to taking control, compare the number of items listed on the tape accompanying the letter with actual items to ascertain whether any items have been removed.

Correspondent Bank Accounts - The following audit steps are available relative to these accounts:

1. A comparison of the daily total for several days of paid and canceled drafts drawn on correspondent banks with the general ledger entries for the same days may reveal discrepancies. In particular, this test should be made for the date of the last examination and for the following several days.
2. Review of past reconcilements should emphasize large outstanding items, unusual activity, forced balancing, and continuous unreasonable delays in crediting correspondents for their charges.
3. Cross entries on the same day between correspondent accounts may indicate possible "kiting" of shortages between correspondent accounts.
4. Delay in remitting for cash letters can be used to cover defalcations.
5. Coin and currency transactions reflected on correspondent accounts should be

compared to a bank's increase or decrease in the cash account on those particular days.

Tellers and Cash - Tellers' daily cash records can be inspected for possible discrepancies such as forced balancing, unusual charges or an excessive total and number of cash items. Items drawn on or by bank personnel should always be verified as to final payment or disposition. All work can be checked for prior endorsements and dates which may indicate a teller has been carrying these items for a long period.

Suspense Accounts - In many banks, asset and/or liability suspense accounts are used as "catchalls". These accounts should be reviewed for large or unusual items. In some instances, suspense accounts have been used for concealment of shortages, worthless assets, and deposit diversions.

Income and Expense Accounts - Test check interest computations on a sampling of loans and securities. Large, regular or unusual debits to income accounts should be verified and interest rebates on loans and monthly service charges on demand deposits may be tested. Finally, interest paid on time and savings deposits can be compared to the amount credited to the respective controls.

General Ledger Accounts - Determine the reason for any unusual or abnormal variations between the various general ledger accounts. Check the validity of any reversing or correcting entries, particularly for a few days immediately following the previous examination. Trace all income closing entries to the undivided profits account; be alert for the diversion to a deposit certificates of deposit have increased beyond normal account of any or all of a particular income account.

Other - Be watchful for any major change, particularly growth, in assets or liabilities. In cases of rapid loan expansion, check for the possibility of out-of-territory loans to insiders. If both loans and time certificates of deposit have increased beyond normal expectations check the source of time certificates of deposit; check for tie-ins between new notes and new certificates of deposit as to common names, common amounts and/or common dates; trace the proceeds of new loans; and determine the source of principal and interest payments on new loans.

V. INFORMATION SYSTEMS

Rapid changes in information systems technology have vastly altered the methods by which financial institutions process data. There may be any number of mediums incorporated within the institution to accomplish data processing needs. Networks are increasingly prevalent in the present multi-location banking environment. As with any other function in banking, operation of information systems presents certain risks and may ultimately impact safety and soundness of the institution. For this reason, the operation and control over information systems should be identified and reviewed at every examination.

Protecting or securing information and facilities that process and maintain information is vital to the continuity of operations. It is essential that information be accurate, safeguarded and provided without interruption. In order to maintain continuity and reliability of information, institutions should, at a minimum, formulate a comprehensive security plan to ensure that operations and data are not vulnerable to undue risks and exposures. The plan should, at a minimum, address: 1) physical security; 2) data security; and 3) backup and contingency planning.

The FFIEC Information Systems Examination Handbook serves as a reference for the examination of these systems. The Handbook contains information systems examination procedures, examination report format, workprograms and related laws, regulations and examination policies. Sections 4 and 5, Operations and Information Systems Security, provide the examiner with fundamental principles of internal controls in all information processing environments.

The Information Systems Workprogram for Community Financial Institution Examination (Community Workprogram) is the primary examination tool for evaluating the most commonplace information processing systems. It is designed to assist the examiner in the evaluation of internal routine and control procedures over in-house and serviced information processing systems. The Community Workprogram includes sections for microcomputers, networks, ATMs, point of sale (POS) and Automated Clearing House (ACH). Also included in the workprogram are questions related to serviced financial institutions and Remote Job Entry (RJE) sites. A cross reference is provided in the workprogram which links questions to the appropriate sections of the FFIEC Information Systems

Examination Handbook.

During the examination, or preferably as part of the pre-examination planning process, examiners should ascertain the various information processing systems in use at that particular institution. Each system should be evaluated in accordance with worksteps in the Community Workprogram, or if appropriate, the FFIEC EDP Examination Work Program.

The Community Workprogram should be used under the following general guidelines:

- Where there is no programming or testing performed and software is vendor-supported for an institution of any size;*
- Where some contract programming and testing is performed for institutions of any size, provided that the Systems & Programming Section of the workprogram is performed and Assistant Regional Director approval is obtained in institutions greater than \$300 million in total assets;*
- The workprogram's ATM, POS, ACH and networks sections may be used in any size institution; and*
- Where all applications are serviced by an outside vendor, the workprogram may be used regardless of institution size.*

The Community Workprogram should not be used when the institution services other financial institutions. The instructions for the Information Systems Workprogram for Community Financial Institution Examinations provide further guidance as to whether a full FFIEC workprogram needs to be completed. Separate Information Systems examination reports are to be completed at the initial examination of in-house and RJE systems. Separate examination reports are also required when an Information Systems composite 3 rating or worse is likely to be assigned or was assigned at the most recent examination. The composite rating as well as each of the four component ratings must be assigned with the exception of the Systems and Programming component for RJE's where a "0" should be assigned. For in-house systems, this component should reflect management's supervision of program change activity such as implementation of vendor updates and parameter changes.

Examiners are authorized by the Bank Service

Corporation Act to examine the data servicer to the same extent as if services were provided on premises. Further, Section 7(c)(2) of the Act requires the bank to notify their appropriate Federal regulatory agency of any serviced relationship, upon the earlier of, the making of such service contract or the performance of the service.

Management Information Systems

A management information system (MIS) is a system or process which provides the information necessary to effectively manage an organization. MIS is essential in all institutions, but becomes increasingly important in larger more departmentalized organizations. MIS is considered a feedback device and as such is a method for managing risks. The board of directors and senior management determine what information is needed for them to make informed decisions and monitor activities of the institution. Staff correspondingly develops the systems to ensure that the desired information is usable as a performance measurement. There are five essential elements that must be addressed before any MIS can be considered usable. They are: timeliness; accuracy; consistency; completeness; and relevance. Management decisions and strategies may be rendered invalid or, in fact, detrimental should any one of these components be compromised.

In order to evaluate MISs, and ultimately the foundation upon which management's decisions are based, examiners must scrutinize each of the five essential components. First, information must be current and available to all appropriate users to facilitate timely decisions. This necessitates prompt collection and editing of data. Secondly, a sound system of internal controls must be in place to ensure the accuracy of data. Information should be properly edited and reconciled, with the appropriate control mechanisms in place. A comprehensive internal and external audit program would greatly facilitate this endeavor. Strategies and decisions can not be adequately monitored or measured unless information provided is consistent. Variations in how data is collected or reported can distort trend analysis. Any change in collection or reporting procedures should be clearly defined, documented and communicated to all users. Information provided by MIS mechanisms must be complete. Lastly, information provided must be relevant. Details which are inappropriate, unnecessary or unsuitable are of no value in effective decision-making. Decision-makers can not fulfill their responsibilities unless all pertinent information is provided in a comprehensive, yet concise format.

Care should be taken to ensure that senior management and the board of directors receive relevant information in order to identify and measure potential risks to the institution. Sound MIS is a key component of management effectiveness and should be evaluated in relation to the size, structure and decision-making process of each individual institution.

Wire Transfers - Examination Procedures

Electronic fund transfer services can be grouped broadly into wholesale and retail systems. Wholesale systems generally are thought of as large dollar systems. Whereas, retail systems might include automated clearing houses, automated teller machines, point-of-sale systems, telephone bill paying, home banking systems and debit cards. Procedures for review of retail systems are comprehensive and are covered in the FFIEC Information Systems Examination Handbook. Information systems procedures do not cover wholesale wire transfer systems.

Access to wholesale or large dollar transfers is most often provided through the FEDWIRE and CHIPS (Clearing House Interbank Payment System). The latter of which is an international payments clearing system for transactions between domestic and foreign banks. Services available through FEDWIRE include: transfers of funds between member institutions; transfers of U.S. Government and Federal agency securities; data transfers such as Automated Clearing House payment files; and administrative and research information. Member institutions may access FEDWIRE by three methods: 1) off-line via telephone with Federal Reserve Bank; 2) dial up access via a PC based system; or 3) direct computer interface.

Although there is no settlement risk in the FEDWIRE system, there may be exposure due to errors and omissions and fraud. Because of these risks, a review of credit risks and control systems for wholesale wire transfer systems should be conducted at each safety and soundness examination. The Wire Transfer questionnaire, found in the Automated Report of Examination will facilitate this review. The questionnaire may be used as a workpaper. Deficiencies receive treatment similar to other internal routine and controls comments in the report of examination.

VI. OTHER RELATED MATTERS

Lost and Stolen Securities Program (SEC Rule 17f1)

All insured banks as well as brokers, dealers, and other securities firms are subject to the rule and must register with the Securities Information Center, Inc. (SIC).

Registration - All reporting institutions (e.g., insured banks) must be registered with SIC as either a direct inquirer or indirect inquirer. Indirect inquirers must designate a correspondent bank or securities firm to act as a direct inquirer on their behalf.

Reporting Requirements - All securities discovered missing, lost, stolen, or counterfeit, which are or were in the bank's possession or control must be reported on Form X17F1A. Copies of all reports must be sent to the registered transfer agent for the issue involved. Counterfeit securities and stolen securities involving suspected criminal activity must also be promptly reported to the appropriate law enforcement authority. Since specific time periods for reporting are prescribed, examiners must consult the text of Rule 17f1 to ascertain the bank's compliance with the time periods corresponding to each discovery of lost, stolen, or counterfeit securities. Banks must report recovery or finding any security previously reported as lost or stolen to the appropriate instrumentality and to the registered transfer agent within one business day. If a report was made to a law enforcement agency, a report of recovery must also be made to that agency.

Inquiry Requirements - Banks must make an inquiry to SIC for every security which comes into their possession unless (1) received directly from the issuer or issuing agent at the time of issue; (2) received from another reporting institution or Federal Reserve bank or branch, or a securities drop which is affiliated with a reporting institution; (3) received from a customer of the bank, and the security is registered in the name of the customer or its nominee or was previously sold to the customer, as verified by the internal records of the bank; or (4) the security is part of a transaction involving bonds of less than \$10,000 face value and stocks of less than \$10,000 market value. The limit applies to the aggregate transaction amount, not to the individual security.

The following types of securities are not subject

to the reporting and inquiry requirements: (1) registered securities of the U. S. Government, any agency or instrumentality of the U. S. Government, the International Bank for Reconstruction and Development, the InterAmerican Development Bank, or the Asian Development Bank, and counterfeit securities of such entities; (2) security issues not assigned CUSIP numbers; and (3) bond coupons.

Recordkeeping - Banks shall maintain and preserve for three years copies of all Forms X17F1A which were used to report securities in accordance with the rule and all confirmations or other information received from the SIC as a result of inquiry into the system. Banks which have registered as indirect inquirers should maintain evidence of inquiries made through direct inquirers to the same extent required of direct inquirers in accordance with this section.

Examination Considerations - Examiners should review the requirements of Rule 17f1 with bank management to ascertain their knowledge and understanding of the rule. Written policies and procedures should be reviewed to determine adherence to the provisions of the rule. The examiner should also review the bank's audit procedures covering the lost and stolen securities program and ascertain whether documentation is adequate to determine compliance with the rule.

Test checks of the bank's inquiry procedures can be effectively integrated into the examination process. Inquiry will most likely be required for securities coming into the bank's possession as collateral for loans or as assets received by the bank's trust department. Examiners can determine from the actual security whether inquiry of the system is required. A subsequent check of the bank's inquiry records can determine compliance with Rule 17f1. Noncompliance should be reported as an apparent violation of SEC Rule 240.17f1 on the violations page of either the commercial or trust report of examination.

Improper and Illegal Payments by Banks and Bank Holding Companies

The FDIC along with the other Federal banking agencies have issued a "Joint Policy Concerning Improper and Illegal Payments by Banks and Bank Holding Companies." This statement refers to additional examination procedures to evaluate the effectiveness of individual institution's controls

for ensuring that improper and illegal payments are not undertaken. The principles enunciated in the statement cover both the Foreign Corrupt Practices Act and the Federal Election Law. The examination procedures described below are centered primarily on detecting violations of these two laws.

Examination Procedures

1. Determine whether the bank has a policy prohibiting improper or illegal payments, bribes, kickbacks, loans, and the like covered by statutes. If the bank has a policy, review and analyze it for adequacy.
2. Determine how the policy, if any, has been communicated to officers, employees or agents of the bank.
3. Review any investigative study performed by or on behalf of the board of directors evaluating the bank's policies and operations concerning the advance of funds in possible violation of the statutes. In addition, ascertain whether the bank was investigated by any other government agency with respect to a possible violation of the statutes and, if so and available, review the materials generated by such an investigation.
4. Review and analyze any internal and external audit program employed by the bank to determine whether the internal and external auditors have established appropriate routines to discover improper and illegal payments under the statutes. To determine the adequacy of any audit programs, the examiner should complete the following procedures:
 - During the review of audit programs, determine whether the programs remind the auditors to be alert to any unusual entries or charges which might be improper or illegal payments to persons or organizations covered by the aforementioned statutes;
 - Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act and the Federal Election Law and whether audit programs have been developed to check compliance with those laws;

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- Review such programs and the results of any audits.
5. Analyze the general level of internal control to determine whether there is sufficient protection against improper or illegal payments under the aforementioned statutes being inaccurately recorded on the bank's books.
6. If the review and analysis under paragraphs 4 and 5 indicate that either the audit program or the internal controls or both of the bank are inadequate, then the examiner should perform the following verification techniques:
- Randomly select charged off loan files and determine whether any charged off loans are to foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act or are to persons covered by the Federal Election Law;
 - Review bank controlled accounts on a random sample basis, such as dealer reserves and cash/collateral accounts, to determine the validity of entries and notification procedures to the customer of activity. With respect to official bank checks, review copies of the checks and supporting documentation on a random sample basis for unusual items or any checks to persons or organizations which may be in violation;
 - For those significant income and expense accounts on which verification procedures have not been performed elsewhere, analyze such accounts for the period since the last examination and obtain by discussion with bank personnel and the review of supporting documents explanations for the significant fluctuations and unusual items noted.
7. Examiners should be alert in the course of usual examination procedures for any transactions, or the use of any bank services or equipment, which might represent violations. Examiners should be especially alert with respect to:
- Commercial and other loans, including participations, which may have been made in connection with any political campaigns;
 - Income and expense ledger accounts for unusual entries and significant entries from an unusual source;
 - Activity in overdrafts and accounts of directors, officers, and employees;
 - Reconcilement of bank controlled accounts such as official checks and escrow accounts.
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